MCI

MCI Telecommunications Corporation

1801 Pennsylvania Avenue NW
Washington, DC 20006
202 887 2048

Leonard S Sawicki
Director
FCC Affairs

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July 10, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: CC Docket 96-112: Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services

Dear Mr. Caton:

Today, Mary Brown, Larry Fenster and I delivered the enclosed materials and discussed them with Andrew Mulitz, Whitey Thayer, Bob Loube, and Clara Kuehn of the Common Carrier Bureau. MCI also discussed and delivered a copy of the paper: "Analysis of Incumbent LEC Embedded Investment", Reply Comments of AT&T, Attachment C, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, May 30, 1996.

Please include the enclosed materials and Attachment C of AT&T's Reply Comments in CC Docket No. 96-98 in the record of this proceeding.

Sincerely,

Leonard S. Sawicki

Leonard Sawicki

Attachments

cc: Ms. Kuehn
Mr. Loube
Mr. Mulitz
Mr. Thayer

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Comparison of Allocation Methods & Estimates: CC Docket 96-112		
Party	**Allocation Factor Method**	**Common Share to Unregulated**
US West	50/50 split, weighted by subscribers.	**10%** (20% penetration)
Pac/Nev Bell	Keep Current CAMs	**15%** (From PT's VDT)
SWB	Ratio of Subscriber Connections	**20%** (20% penetration)
Nynex	Ratio of Subscriber Connections	**20%** (20% penetration)
GVNW	Ratio of Subscriber Connections	**20%** (20% penetration)
Bell Atlantic	Keep Current CAMs	**28%**
USTA	Keep Current CAMs	**28%** (From BA's VDT)
Ameritech	Keep Current CAMs	**28%** (From BA's VDT)
BellSouth	Keep Current CAMs	**28%** (From BA's VDT)
Broadband	Keep Current CAMs	**28%**
SNET	Each bband service receives an equal share of broadband costs, except non-bband telephone service also gets an equal share. Excludes all nonbband costs common to video and telephony	**37%** (assumes 75% of costs common costs to telephone + video are broadband)
Alabama	Not specified	**50%+**
New York	Not specified	**50%**
GCI	Not specified	**50%**
California	50/50 split with stand alone cap that declines	**50%**
Florida	Ratio of video capable loops to total loops	**50%**
AT&T	Ratio of Video Incremental to Video Plus Telephone Incremental	**50%**
PAOCA	Ratio of video stand alone to sum of telephone and video stand alone	**50%+**
MCI	Ratio of video stand alone to sum of video and telephone stand alones	**55%**
GSA	Ratio of Video Incremental to Video Plus Telephone Incremental	**72%**
TW	Not specified	**75%**
Cox	Not specified	**75%**
NCTA	Ratio of Video Incremental to Video Plus Telephone Incremental	**75%+**
CCTA	One minus the ratio of incremental telephone to incremental video	**76%+**

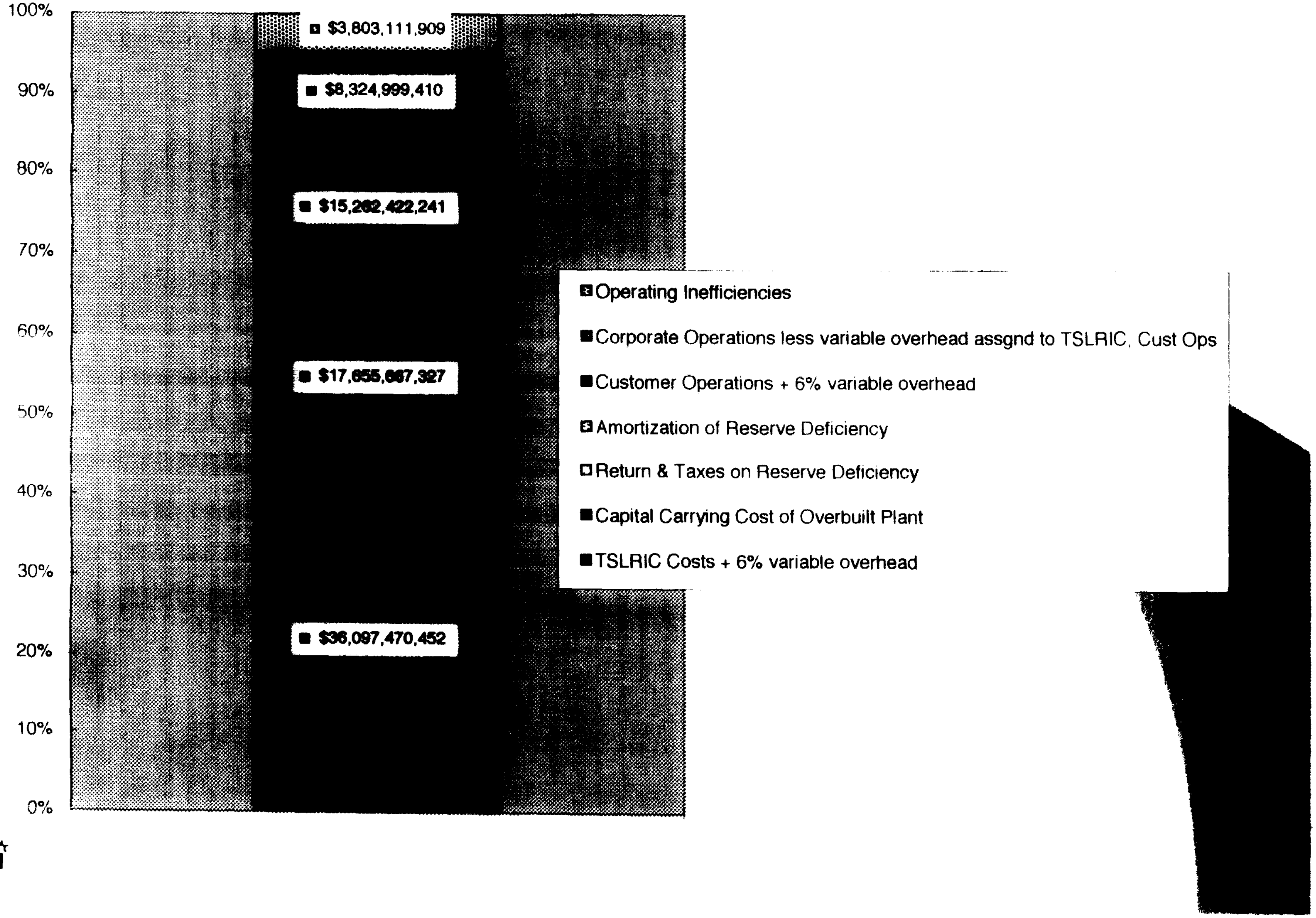
BellSouth Official Toll Network - Florida

LATA Pair		Active Fiber Pairs	Protect Fiber Pairs	Dark Fiber Pairs	Active DS-3s	Potential DS-3s	Excess Capacity
Southeast	Orlando	1	1	16	8	408	98.0%
Orlando	Daytona	1	1	10	11	264	95.8%
Daytona	Jacksonville	1	1	16	10	408	97.5%
Gainesville	Jacksonville	1	1	13	3	336	99.1%
Jacksonville	Thomasville	1	1	10	3	132	97.7%
Jacksonville	Macon	1	1	4	4	60	93.3%
Panama City	Thomasville	1	1	1	3	24	87.5%
Panama City	Pensacola	1	1	1	3	24	87.5%

"Potential" DS3 circuit capacity assumes activation of dark fibers using same electronics as used on active pairs, existing spare circuits and Nx1 redundancy.

Source: Southern Bell response to discovery in FPSC Docket 92-0260

Components of the Revenue Requirement



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Components of the Revenue Requirement

Total Revenues - Tier One Companies '93			$	81,997,412,000		
Total TSLRIC Wholesale Cost			$	36,097,470,452		
The "Gap"			$	45,899,941,548	$	45,899,941,548
Model Investment	$	131,320,817,108				
Actual Investment	$	256,803,243,000				
Overbuilt Plant	$	125,482,425,892				
Capital Carrying Cost of Overbuilt Plant			$	17,655,667,327	$	28,244,274,221
Depreciation Reserve Deficiency	$	3,314,926,000				
Return & Taxes on Reserve Deficiency			$	438,306,882	$	27,805,967,339
Amortization of Reserve Deficiency			$	414,365,750	$	27,391,601,589
Customer Ops ('93 Actual)	$	13,184,107,220				
Plus: CapCost of GSF	$	2,078,315,021				
Total Customer Ops	$	15,262,422,241	$	15,262,422,241	$	12,129,179,347
Corporate Ops ('93 Actual)	$	10,148,262,000				
less: overhead assigned to TSLRIC	$	2,165,848,227				
less: overhead assigned to Customer Ops	$	791,046,433				
Net Corporate Ops	$	7,191,367,340				
Plus: CapCost of GSF	$	1,133,632,071				
Total Corporate Ops	$	8,324,999,410	$	8,324,999,410	$	3,804,179,937
Uncollectibles	$	1,068,028	$	1,068,028	$	3,803,111,909
Operational Inefficiencies			$	3,803,111,909	$	-

Contradictions Between RBOC OVS Positions[1] and Local Competition Positions[2]

There appear to be serious contradictions between the RBOCs' view of how common costs should be allocated, trends in the cost of telephone service, the role of accounting (embedded) cost concepts, and the effect of these on entry depending on whether the service in question is regulated or nonregulated.

Contradiction Estimating the Cost of Services. LECs want OVS costs measured according to incremental costs, with minimal sharing of common costs, but oppose estimating regulated unbundled network elements according to their incremental costs, arguing that every service should equitably share common costs.[3] For example:

> "...some comments assert a right for telephone customers to share in the benefits of the economies of scope resulting from LECs' nonregulated activities. There is no basis in law or economics for such a right." BellSouth OVS Reply Comments, p. 10.

> "An economically efficient firm is obliged to recover at least incremental cost on a specific service, but also to require all of its services to contribute toward the recovery of shared and common costs." BellSouth Local Competition Comments, p.52.

Contradiction in Expectations of the Cost of Telephone Service. RBOCs contend that telephone costs will be increasing over time in the OVS proceeding, but they contend telephone costs will be declining over time in the Local Competition Proceeding.[4] For example:

> "...the loop cap method assumes incorrectly that loop costs continually decrease over time." Pacific Bell OVS Comments, p.12

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[1]See LEC Comments and Reply Comments in Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services (OVS Comments and OVS Reply Comments), CC Docket No. 96-112.

[2]See RBOC Comments (in Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 (Local Competition Comments), CC Docket No. 96-98, May 16, 1996.

[3]See Ameritech OVS Comments at 9, Ameritech Local Competition Comments at 60; Bell Atlantic OVS Comments at 5, Bell Atlantic Local Competition Comments at 35; Bell South OVS Reply Comments at 10, Bell South Local Competition Comments at 52; Nynex OVS Comments at 3, Nynex Local Competition Comments at 42; Pacific Bell OVS Comments at iv, and Pacific Bell Local Competition Comments at 74

[4]See Bell Atlantic OVS Comments at 11; Bell South OVS Comments at 20, Bell South Local Competition Comments at 52; Nynex OVS Comments at 13, Nynex Local Competition Comments at 50-51; Pacific Bell OVS Comments at 12; and Bell Atlantic OVS Comments at 11.

"...LECs are facing conditions of long-run decreasing costs for network facilities..." Nynex Local Competition Comments, p. 50.

Contradiction in Attitude Towards Rate of Return Regulation. In the Local Competition proceeding, RBOCs defend their right to recover the embedded accounting costs which originated with regulatory concepts developed in rate of return regulation. In OVS, they argue that price caps obviate the need for cost allocations and reference to accounting costs that originated in rate of return concepts.[5] For example:

"...basing rates on incremental cost would deny LECs the ability to recoup any unrecovered historical investment." Bell Atlantic Local Competition Comments, p. 36.

"With the end of rate of return regulation, the need for such (accounting) data disappears." Bell Atlantic OVS Comments, p. 2.

Contradiction in Effect of Incremental Pricing on Entry. In the Local Competition proceeding, RBOCs argue that setting network elements at incremental costs will undermine facilities-based telephone competition, but argue that incremental pricing will spur facilities-based competition in video markets. They show no concern that incremental pricing of OVS might stifle investment by DBS and other facilities-based video competitors.[6] For example:

"[Incremental pricing]...would also deter potential entrants in the local exchange market from constructing their own facilities, since new entrants would incur greater costs by building facilities than by purchasing them from the incumbent LECs." Nynex Local Competition Comments, p. 44.

"To the extent the Commission's rules provide for an allocation of costs...in excess of...incremental costs...this will distort economic decision making and may deter entry." Nynex Ovs Comments, p. 9

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[5]See Ameritech Local Competition Comments at 62; Bell Atlantic OVS Comments at 2, Bell Atlantic Local Competition Comments at 36; Bell South OVS Reply Comments at 4, Bell South Local Competition Comments at 57; Nynex OVS Comments at 5, Nynex Local Competition Comments at 46; Pacific Bell OVS Comments at 3, and Pacific Bell Local Competition Comments at 66; and SBC OVS Comments at 24, SBC Local Competition Comments at 88.

[6]See Ameritech OVS Comments at 2, Ameritech Local Competition Comments at 72; Bell Atlantic OVS Comments at 5, Bell Atlantic Local Competition Comments at 38; Bell South OVS Reply Comments at 5, Bell South Local Competition Comments at 54; Nynex OVS Comments at 9, Nynex Local Competition Comments at 44; Pacific Bell OVS Comments at 15-16, and Pacific Bell Local Competition Comments at 70; US West OVS Comments at 3, US West Local Competition Comments at 42; and SBC OVS Comments at 14, SBC Local Competition Comments at 92.

**CONTRADICTIONS BETWEEN RBOC OVS POSITIONS
AND POSITIONS TAKEN REGARDING
THE DEVELOPMENT OF COMPETITION FOR LOCAL TELEPHONE SERVICE**

CONTRADICTION 1: HOW DOES THE PRICE OR COST OF A SERVICE GET DETERMINED. LECS WANT OVS COSTS MEASURED ACCORDING TO INCREMENTAL COSTS WITH MINIMAL SHARING, BUT DO NOT WANT INCREMENTAL COSTING TO BE USED TO MEASURE UNBUNDLED NETWORK ELEMENT COSTS, ARGUING THAT EVERY SERVICE SHOULD SHARE EQUITABLY IN COMMON COSTS.

Company	OVS Docket CC 96-112	NETWORK ELEMENTS Docket CC 98-96
Ameritech	"...use of exogenous treatment to effectuate additional 'sharing' would violate the Commission's price cap rules, ...and would amount to confiscation." Reply Comments, p. 9.	"...rates ~must cover the forward-looking incremental costs, the joint costs, and the common costs of the service or facility." Comments p. 60
Bell Atlantic	"The Commission recognizes that cost allocation of shared plant is 'inevitably imperfect,' and so as a matter of policy 'intentionally' errs on the side of allocating a 'significant' part of common costs to nonregulated services. For the Commission then to import these costs into the price cap formula, resuscitates cost allocation requirements and gives them new prominence." Comments, p. 5.	"...prices for interconnection and network elements cannot be set at incremental cost, as some claim, but instead must allow the LECs to recover the <u>total</u> costs of constructing and operating their networks." Comments, p. 35.
BellSouth	"...some comments assert a right for telephone customers to share in the benefits of the economies of scope resulting from LECs' nonregulated activities. There is no basis in law or economics for such a right." Reply Comments, p. 10.	"An economically efficient firm is obliged to recover at least incremental cost on a specific service, but also to require all of its services to contribute toward the recovery of shared and common costs." Comments, p.52.

Nynex	"There is no basis in this proceeding for revising cost allocation rules so as to drive a greater proportion of embedded telephone plant to nonregulated activities." Comments, p. 3.	"allow the LECs a reasonable opportunity to recover their actual costs of service, including a return on investment used to provide a service and a reasonable allocation of joint and common costs." Comments, p. 42
Pacific	Exogenous cost treatment (that allocates common costs to new services) is not justified when new services share embedded facilities..." Comments, p. iv.	""A proxy approach is certainly preferable to requirements that rates be set by measures, such as TSLRIC, that do not allow recovery of all joint and common costs." Comments, p. 74.
USWest		"The basic economic principle of 'cost causality' also requires that costs should be allocated to and recovered from the service or customer which caused them. Under this principle, those CLECs who purchase unbundled network elements should pay prices that cover all of the costs associated with the unbundled network elements they buy..." Comments, p. 23
SBC	"Basing exogenous cost reduction on the benefits arising from LEC economics of scope (i.e. sharing common costs), the Commission would be forcing regulated telephone service consumers to receive all of these benefits..." Comments, p. 24.	"...prices set equal to the incremental cost...will fail to contribute toward the recovery of an ILEC's joint, common, and other costs. For that reason, prices set equal to incremental cost are too low." Comments, p 90.

CONTRADICTION 2: LECS EXPECT THE COST OF TELEPHONE SERVICE TO INCREASE IN OVS, BUT TO DECREASE IN 251

Company	OVS	NETWORK ELEMENTS
BellSouth	There will be a "... rapidly growing demand for new telecommunications services, particularly broadband telecommunications services. This demand drives network technology and costs [which]...cause increased costs." Comments, p. 20	"...a LEC experiences significant economies of scale..additional units of service can be provided at a lower unit cost than previous units..." Comments, p. 52.
Nynex	"This method (capping telephone costs) assumes that carriers will no longer invest in loop plant." Comments, p. 13	"...LRIC pricing would prevent a LEC from recovering its total costs...[due to] economies of scale...LECs are facing conditions of long-run decreasing costs for network facilities...the forward-looking investment...will be less than the investment that a LEC has already purchased..."Comments, pp 50-51.
Bell Atlantic	"Any ceiling must allow for increases in the regulated rate base caused by factors unrelated to the provision of non-regulated services...require annual upward adjustments to the cap..." Comments, p. 11.	
USWEST	"The Commission should not fail to recognize that the need to continue to provide high-quality, up-to-date service at an affordable price requires LECs to upgrade and replace facilities." Comments, p. 14. By not reflecting ...the cost of supplementing the network at a later date, the Hatfield Model understates the TSLRIC of basic local telephone service." Reply Comments, p. 5.	

Pacific	"...the loop cap method assumes incorrectly that loop costs continually decrease over time." Comments, p.12	
Ameritech		
SBC	"A ceiling assumes that the loop plant or other capped plant category will not be upgraded or replaced to furnish improved new regulated services or for purposes of growth in regulated service..." Comments, p. 12.	

CONTRADICTION 3: LECS DON'T MIND STAND ALONE COSTS FOR UNBUNDLED ELEMENTS, BUT DO FOR CAPPING TELEPHONE SERVICE IN OVS

Company	OVS	NETWORK ELEMENTS
BellSouth	"The Commission should not establish a ceiling [based on telephone service stand alone costs] on the amount of costs that may be assigned to regulated activities. Comments, pp 19-20.	...if neither a market price nor an analogous access service were available as an upper bound measure, then the appropriate basis would be stand alone costs." Comments, p. 56.
Nynex	"This method assumes that carriers will no longer invest in loop plant." Comments, p. 13.	
Bell Atlantic	"Any ceiling must allow for increases in the regulated rate base caused by factors unrelated to the provision of non-regulated services...require annual upward adjustments to the cap..." Comments, p. 11.	
Pacific	"...the loop cap method assumes incorrectly that loop costs continually decrease over time." Comments, p	

Ameritech	"The commission should forbear from applying its cost allocation rules to pure price cap carriers." Comments, p. 3.	
SBC	"After a period of time, the 'stand-alone' costs allowed might have little, if any, relationship to the actual costs caused by regulated activities." Comments, p. 11.	

CONTRADICTION 4: LECS RELY ON RECOVERY OF EMBEDDED ACCOUNTING COSTS (A RATE OF RETURN CONCEPT) FOR NETWORK ELEMENT PRICING, BUT ESCHEW ANY REFERENCE TO ACCOUNTING COSTS AND OTHER COST-BASED OR RATE OF RETURN CONCEPTS FOR OVS.

Company	OVS	NETWORK ELEMENTS
Ameritech		"...the Commission must ensure that incumbent LECs have the opportunities to recover all costs." Comments, p. 62. "...public policy demands recovery of such residual costs at least until the issue of subsidies is resolved..." Comments p. 77.
Bell Atlantic	"The allocation of costs between regulated and non-regulated services...created accounting data on which regulators set 'cost-based' rates. With the end of rate of return regulation, the need for such data disappears." Comment, p. 2.	"...basing rates on incremental cost would deny LECs the ability to recoup any unrecovered historical investment." Comments, p. 36.

BellSouth	"Cost allocations relate to the former regulatory regime, in which LECs' rates were based on accounting costs." Comments, p.4. "It looks backward to rate-of-return regulation (cost allocation) ... Continued reliance on regulatory tools of the past will hinder the development of competition..." Comments, p. 23.	"It is appropriate that embedded costs be included in the measure of total costs that incumbent LECs be permitted to recover...[t]hese costs were properly incurred pursuant to regulatory oversight..." Comments, p. 57
Nynex	"In the current FCC price cap environment, the relevance of regulated costs to rates is greatly diminished..." Comments, p. 5.	"...the term 'cost' under Section 251(d)(1) for interconnection and network elements includes the LECs' cost of capital..." Comments p 46.
Pacific	"Cost allocation requirements are irrelevant for price cap LECs that have elected the no sharing option." Comments, p. 3.	"Historical cost has been the accepted basis on which to determine a fair return ever since Hope Natural Gas." Comments, p 66 "A utility should be compensated 'for all prudent investments at their actual cost when made..." Comments, p. 70.
USWest		"...network element costs are reasonable if they...result in US West covering its total expenses and investment plus a reasonable profit." Comments, p. 43.
SBC	"...prices are not determined by regulated accounting costs, especially if a LEC is not subject to sharing obligations." Comments, p. 24.	"Rate structures that do not recover total costs would conflict with the statutory requirement that rates be 'based on the [LEC's] cost,' and would not generate profits." Comments, p. 88.

CONTRADICTION 5: LECS ARE CONCERNED THAT SETTING NETWORK ELEMENTS AT INCREMENTAL COSTS LOW WILL UNDERMINE FACILITIES-BASED TELEPHONE COMPETITION, BUT ARGUE THAT INCREMENTAL PRICING WILL SPUR FACILITIES-BASED COMPETITION IN VIDEO MARKETS. THEY SHOW NO CONCERN ON OVS FRONT THAT INCREMENTAL PRICING MIGHT STIFLE INVESTMENT BY DBS AND OTHER FACILITIES-BASED COMPETITORS.

Company	OVS	NETWORK ELEMENTS
Ameritech	"...carriers will have less, not more, incentive to invest in infrastructure...if the Commission uses its cost allocation rules to intentionally re-direct costs from regulated to nonregulated..." Comments, p. 2.	"Moreover, rates that do not reflect all costs will impede the development of facilities-based competition..." Comments, p. 72.
Bell Atlantic	"Requiring an exogenous cost adjustment (that allocates common costs to OVS) ... penalizes those companies that invest in shared facilities to provide new services..." Comments, p. 5.	"setting rates <u>at</u> incremental cost will <u>not</u>, as some have claimed, create incentives for new entrants to build their own facilities. In fact, it will do quite the opposite...to deter entry by legitimate facilities-based competitors." Comments, p.38.
BellSouth	"If the Commission ... allocate[s] more costs to nonregulated activities [by not using incremental costing for OVS]...it will provide a major disincentive for LECs to deploy advanced telecommunications capabilities." Comments, p. 15.	"In these circumstances (LRIC pricing), there would be little or no incentive for new entrants to make efficient investments in their own facilities and networks." Comments p 54.
Nynex	"To the extent the Commission's rules provide for an allocation of costs...in excess of...incremental costs...this will distort economic decision making and may deter entry." Comments, p. 9.	"[TSLRIC pricing]...would also deter potential entrants in the local exchange market from constructing their own facilities, since new entrants would incur greater costs by building facilities than by purchasing them from the incumbent LECs." Comments p 44.

Pacific	"...improper allocation of costs to a nonregulated service carries significant risk of nonrecovery...could negatively influence management decisions about introducing new products and services." Comments, pp 15-16.	"Rates set at TSLRIC would discourage efficient entry and useful investment..." Comments, p. 70.
USWest	"...any formula or approach that arbitrarily over allocates common costs to nonregulated services ...would retard investment on the nonregulated side of the incumbent LEC's business..." Comments, p.3.	"Network elements priced too low could disrupt services of incumbent LECS, reduce their incentives to invest, and make investment by competitors unlikely and imprudent." Comments, p. 42.
SBC	"...if the Commission required an inflated fixed factor (i.e. equitable sharing of common costs) and used that factor in determining prices, it could result in a video product price which is too high..." Comments, p. 14.	"...prices at, or near, LRIC or TSLRIC would discourage entrants from investing in their own networks..." Comments, p. 92